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(CAP) can provide local exchange services, it is difficult to generate sufficient volume to justify investing in a switch. Therefore, while CAPs are permitted to compete for interstate switched access services, they have been successful (and then only to a degree) only in the market for special access (non-switched) services. Notwithstanding this limited success in the special access market, the entire CAP industry has captured less than one percent of the revenue of the \$25 billion access market.[4] The BOC assertion that a market is competitive when an entire industry is able to capture less than one percent of the market after competing for 10 years is ludicrous.

B. Technical Barriers to Entry

The Motion to Vacate asserts that cable television systems and wireless services may soon compete with existing local exchange networks. Today, however, there is not a single cable system or wireless network that effectively competes with an incumbent local exchange carrier.

Moreover, it likely will be years before these potential competitors develop networks that are functionally equivalent to the BOCs. The technological obstacles facing cable operators that seek to provide competitive local exchange service were capably described to the MFJ Court by Bell Atlantic earlier this year. In seeking a waiver for its proposed merger with Tele-Communications, Inc., Bell Atlantic told the Court:

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4/ See, e.g., Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, Comments of AT&T at 9 (filed May 9, 1994).

> Absent modifications, cable architecture is poorly suited to provide switched, two-way telephone services to individual customers.[5]

In addition to this fundamental architectural problem, Bell Atlantic told the Court that cable systems lack a number of capabilities that are essential to the provision of telephone service. Specifically, Bell Atlantic stated that cable systems lack: (1) the sophisticated switching systems necessary to route telephone traffic; (2) the specialized billing systems needed to handle multiple services and large volumes of individually metered transactions; and (3) the specialized Operations Support Systems to handle facilities provisioning, administration and maintenance, traffic management, service evaluation, and the planning and engineering associated with switched services. Oliver Affidavit at 4-5.

As to the ability of cable operators to compete by providing Personal Communications Services (PCS), Bell Atlantic relied on an affidavit of Dr. Richard Green, President and CEO of Cable Television Laboratories. According to Dr. Green:

> [T]he commercial reality is that cable's provision of personal communications services is neither certain or immediate . . . it is far from clear whether radio based systems will ultimately be able to compete with wired systems for the provision of ordinary local telephone services.[6]

None of the shortcomings outlined in the Bell Atlantic Motion is mentioned in the Motion to Vacate to which Bell Atlantic is a party. Either effective local exchange

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5/ Bell Atlantic's Request for an Expedited Waiver Relating to Out of Region Interexchange Services and Satellite Programming Transport ("Bell Atlantic Motion"), Affidavit of Brian D. Oliver ("Oliver Affidavit") at 4 (filed January 20, 1994).

6/ Oliver Affidavit at 6, citing Affidavit of Dr. Richard Green, submitted in Chesapeake and Potomac Telephone Company v. United States, 830 F. Supp. 909 (E.D. Va. 1993).

competition is uncertain from a technological perspective or it is not. Placed side-by-side, the Bell Atlantic Motion and the Motion to Vacate raise serious questions about Bell Atlantic's willingess to distort the truth to achieve desired ends.

### C. Economic Barriers to Entry

Even if legal barriers to entry are removed tomorrow, it will be years before BOC competitors are able to overcome the economic barriers to competition that exist today. Those barriers include: (1) lack of regional reasonably priced interconnection; (2) BOC control over numbering resources; (3) lack of multi-state or regional ubiquity and name recognition.

#### 1. Interconnection and Reciprocal Compensation

The FCC adopted rules in 1992 requiring the BOCs to provide expanded interconnection options to CAPs, IXCs and end users. The intent of the Commission's expanded interconnection rules was to give competitive choices to customers that were not located in areas served by competing networks.[7/]

Although the Commission's rules were adopted two years ago, the Commission has yet to find that the BOCs have tariffed expanded interconnection at reasonable rates.[8/] Among other deficiencies, the BOC tariffs attempted to load

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7/ Without expanded interconnection, a CAP can serve a customer only if its network goes to the customer's building. In many cases, CAPs are denied access to buildings served by the BOCs or are required to pay fees not imposed on the BOCs.

8/ "We find that the LECs have not demonstrated that their originally filed rates for (continued...)

extraordinary overhead costs into the interconnection rate. In many cases, BOCs proposed overhead loadings for expanded interconnection that exceeded the overhead reflected in rates for retail access services provided by the BOCs. Id. at 8359. Under such a tariffed pricing scheme, it is impossible for any CAP to serve IXC customers without losing money.[9/]

In addition to strategically pricing expanded interconnection options to make them economically unattractive to potential competitors, the BOCs vehmently opposed the imposition of exanded interconnection obligations, and sucessfully overturned on court review the FCC's requirement that BOCs provide physical interconnection within their end offices.[10/] These are not actions that should encourage either the Department or the MFJ court that the BOCs intend to permit competition to take any lasting root.

Interconnection will become an increasingly troublesome issue as CAPs and others seek to enter the local exchange market. To date, regulators in a few states have required competitive local exchange providers to negotiate reciprocal compensation arrangements with incumbent LECs.[11/] The potential for LEC abuse in this situation is tremendous. For the foreseeable future the LEC will terminate significantly more CAP calls than the CAP will terminate LEC calls, and therefore the LEC has every incentive to demand

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8/ (...continued)
expanded interconnection are just and reasonable in compliance with the Communications Act." Local Exchange Carrier Rates, Terms and Conditions for Expanded Interconnection for Special Access, First Report and Order, 8 FCC Rcd 8344, 8346 (1993).

9/ Despite these anti-competitive rates, the FCC's options for prescribing reasonable rates under its tariff review regulations have been woefully inadequate.

10/ Bell Atlantic v. FCC, 24 F.3d 1441 (D.C. Cir. 1994).

11/ New York Telephone, Case No. 92-C-0665 (N.Y. PSC Sept. 20, 1993).

an unreasonably high reciprocal compensation rate or to impose unreasonable terms and conditions. In this situation, CAPs that cannot provide local exchange service until mutual compensation agreements are reached with the LEC are essentially powerless to negotiate a reasonable rate. As discussed in greater detail in Section IV, similar concerns exist for potential entrants in the PCS market.

2. Numbering

Another substantial barrier to effective competition in the local exchange market is BOC control over numbering resources. There is no mechanism in place today that enables a customer to switch carriers while retaining its existing telephone number. Business customers often have invested heavily in their existing numbers (e.g., advertising and stationery) and a competing service provider will have to price its services at a rate that compensates the customer for loss of this investment. Residential customers are equally tied to their existing telephone numbers, for reasons that may be more psychological than economic. Until number portability is in place, and there is no timetable or current regulatory requirement for its implementation, the BOCs will have a tremendous strategic advantage over potential competitors.

In most states, BOCs possess an additional competitive advantage by virtue of their control over numbering resources. If a BOC competitor is successful in attracting new customers, it must purchase telephone numbers for those customers from the BOC. Although some states, such as New York, have required incumbents to make telephone numbers available on the same terms as they are used by the telephone company, this is the exception, not the rule. The ability of one competitor to impose costs on another competitor for a key resource is entirely inconsistent with the development of a competitive market.

3. Economies of Scale

An additional competitive advantage the BOCs possess solely by virtue of their monopoly in the local exchange market is their ubiquitous multi-state and regional presence. While there has been some consolidation in the cable industry recently, no cable operator serves a region anywhere as large as the contiguous multi-state regions served by the BOCs. The economies of scale that result from serving multi-state regions are unlikely to be duplicated in the near term by cable operators, who typically operate systems designed primarily to serve no more than a few communities. CAPs and other potential competitors also lack these economies of scale.

Not only do the regional BOCs serve huge territories, but they are required by state regulators to provide high quality services at low rates. While the BOCs continually complain about the "burden" of universal service, in fact this burden is a tremendous competitive advantage in terms of how the BOCs are perceived by customers. This is just one more example of how the BOCs pervasive monopoly presents a substantial economic barrier to entry.

D. Barriers to Entry in Southern California: An Example

The fallacy of the BOCs' assertion that they no longer are monopolists is demonstrated by looking at the market in southern California. Cox operates cable systems in San Diego, Bakersfield and Santa Barbara and it has agreed to purchase systems owned by

Times Mirror in Los Angeles. Under the standards outlined in the Motion to Vacate, southern California is a highly competitive telecommunications market and Pacific Bell will be unable to compete effectively with Cox unless the Decree is eliminated.

The portrait of the marketplace presented in the Motion to Vacate bears no resemblance to today's reality. First, there are state certification barriers to the institution of wired service competition.[12] Second, while Pacific Bell has a fully functioning local exchange network in place, Cox must spend many millions of dollars before it has a network that is technically capable of providing wired local exchange service. Even when the Cox network can serve telephony customers and has succeeded in clustering its cable operations beyond anyone's wildest imagination, it will not have the geographic ubiquity or the scope of Pacific Bell's network, nor will Cox have the name recognition of the incumbent.

Moreover, once a telephony capable network is in place, Cox will bear a heavy burden convincing customers to leave Pacific Bell. For customers located on the Cox network (e.g., existing cable customers), Cox must price its services at a rate that is low enough to: (1) compensate customers for giving up their existing telephone numbers; and (2) compete with Pacific Bell's allegedly "subsidized" rate.[13] For customers not served

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12/ Given the time it has taken the state of California to resolve the issues arising from the institution of intraLATA toll competition due in no small part to the dilatory tactics of PacBell, Cox anticipates a substantial regulatory delay while California develops policies to deal with competitive local exchange providers.

13/ Pacific Bell claims that its local exchange rates are artificially low because "implicit subsidies flow from low-cost areas to high-cost areas and from high margin services to below-cost services. Amendment of Part 36 of the Commission's Rules, CC Docket No. 80-286, Comments of Pacific Bell at 6 (filed October 28, 1994). However, a recent audit of

(continued...)

directly by the Cox network, Cox must bear the additional cost of using Pacific Bell's local loop facilities or building its own facilities to the customer. Because the financial viability of this enterprise also depends on the availability fair and reasonable interconnection rates and terms with PacBell, Cox anticipates that PacBell will, as in the expanded interconnection arena, stonewall competitors by filing strategically priced interconnection rates. Given these substantial obstacles, the ability of Cox to offer truly competitive local exchange service is far from certain.

### E. Comparison of Entry Barriers in the Local Exchange and Interexchange Markets.

The deficiencies in the BOCs' argument that the local exchange market is competitive are readily apparent when judged under the standards the BOCs use to measure competition in the interexchange market. According to the BOCs, the interexchange market is not competitive even though three IXCs operate nationwide fiber optic networks and hundreds of other carriers offer services to end users.[14/] The BOCs cite the high cost of fiber optic networks as a significant barrier to further entry in the interexchange market. Judged by these standards, the assertion that the local exchange market is competitive is

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13/ (...continued)
Pacific Bell demonstrates that the opposite may be true, i.e., that residential services actually subsidize the development of new competitive services. An Audit of the Affiliate Interests of the Pacific Telesis Group, National Association of Regulatory Utility Commissioners (July 1994) ("NARUC Audit").

14/ See Long Distance Carriers and Their Code Assignments, Industry Analysis Division, Federal Communications Commission, released September 27, 1994.

nonsense. Virtually every local exchange market in the country is characterized by a single ubiquitous network. There are few, if any, markets where there exists a second network and surely none with three networks each with the scope and the capability of the LEC local network.

The BOCs also assert the interexchange market is not competitive because MCI and Sprint forever will face higher marginal costs than AT&T and that they never will gain additional market share. Motion to Vacate at 70. Moreover, the BOCs claim this situation is exacerbated by the fact that customers still perceive that AT&T possesses superior technical abilities and a more ubiquitous network.[15] These same problems, however, will face potential entrants into the local exchange market. As stated above, CAPs have been ineffective in the switched access market in part because they lack the economies of scale possessed by the BOCs and other LECs, who handle virtually all of the switched access traffic of the IXCs.

In short, judged under any standard, competition in the local exchange market does not exist today, nor is it likely to develop in the near future.

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15/ Motion to Vacate at 70-71. The BOC's characterization of the interexchange market raises substantial questions regarding claims that BOC entry into this market will benefit consumers. The BOCs will be at a tremendous disadvantage because they do not have nationwide fiber networks in place like AT&T, MCI and Sprint. Furthermore, because well over 90% of interexchange traffic originates and terminates on LEC networks, entry into the interexchange market should have little effect on the BOCs' marginal costs. Thus, absent cross-subsidization, it is unclear how the BOCs would be any more effective than MCI and Sprint in reducing interexchange rates.

## III. EXPERIENCE SHOWS THAT REGULATORY SAFEGUARDS ARE INSUFFICIENT TO PROTECT AGAINST BOC ABUSES OF MONOPOLY POWER IN THE MARKETS IN WHICH THEY NOW PARTICIPATE.

One of the bulwarks of the BOC argument for lifting the remaining MFJ restrictions is that existing regulation is sufficient to protect against any abuses of monopoly power. The Motion to Vacate proudly points to BOC participation in markets adjacent to the local exchange, claiming that this BOC market participation proves that monopoly local exchange power is not being abused. Experience shows that the opposite is true, and that BOCs use their local exchange monopoly with impunity to advantage their own non-local exchange operations, especially in information services. If regulators are unable to stem these abuses in the information services marketplace, it is highly unlikely they would have any more success in the much larger interexchange and equipment marketplaces, where cross-subsidy and other abuses will be much harder to prevent or detect.

### A. BOCs Have Abused Their Existing Monopolies by Discriminating Against ISP Competitors.

One of the most effective ways for a BOC to quash competition in information services is to discriminate against non-affiliated information services providers ("ISPs"). Since the removal of the original MFJ information services restriction, BOCs have discriminated against non-affiliated ISPs in a variety of ways. Typically, the BOCs do not discriminate by charging themselves one price for a service and charging outsiders a different price. Rather, the BOCs use somewhat more subtle mechanisms, such as pricing services they use at relatively low levels, while pricing services used by competitors at relatively high levels. BOCs also use their control over the local exchange network to delay or prevent the introduction of services useful to competitors and to design services so that they will be more useful to the BOC than to non-affiliated ISPs.

1. ONA Price Discrimination

Price discrimination is a very efficient mechanism to aid the BOC's information services while disadvantaging other ISPs. Because tariffing requirements make it difficult to engage in discrimination in the pricing of specific services, BOCs have turned to other approaches, notably pricing different services based on who uses them.

For instance, when BellSouth proposed its first Open Network Architecture tariff in Georgia, it planned to offer ten non-access services. Of the ten services, BellSouth uses four services, and non-BellSouth ISPs use six. According to data provided to the Georgia Public Service Commission by BellSouth, the four services used by BellSouth have average profit margins of 22.23 percent, while the six services not used by BellSouth have average margins of 162.1 percent. The services used by BellSouth had four of the five lowest margins, while the services used by other ISPs had only one of the five lowest margins and the five highest margins.[16] The only rationale presented by BellSouth to justify these disparities was that it had set rates based on "market" considerations.

In the same proceeding, BellSouth also proposed rates that discriminated in favor of its own basic service offerings. BellSouth's ONA tariff proposed offering four different number identification services. Of the four, the one with the lowest price and the

16/ The services and profit margins for each are shown in Exhibit 1.

lowest profit margin also was compatible only with BellSouth's digital Centrex service. BellSouth customers with PBXs, on the other hand, are required to use services that are priced 150 to 300 percent higher, and with profit margins that are 49 to 140 percent higher than the Centrex version of the service. This disparate pricing plainly provides an advantage to Centrex service in BellSouth's competition with PBX vendors, because the cost of calling number identification now is significantly higher for PBX users than for Centrex customers.

### 2. Refusal to Provide Services to Competitors

Another way that BOCs create discriminatory advantages for themselves is in the timing of service availability and the design of services. BOCs choose not to provide services until they want to use them, not when those services are requested by ISP competitors. Similarly, BOCs offer services that they can use, often without any regard for the needs of independent ISPs.

The discrimination described above took place in Georgia when BellSouth decided to enter the voice messaging business. For several years, voice messaging providers requested a service known as call forwarding variable, which permits calls to be forwarded to another number automatically after a certain number of rings or if the original number is busy. Call forwarding variable is an important, widely available service for voice messaging because it makes voice messaging much more convenient for end users. Without this service, end users are required to forward their telephones manually and callers cannot leave messages when the end user's line is busy. BellSouth would not provide this service to competitors, however, until its own MemoryCall voice messaging service became available.[17] Thus, BellSouth effectively limited the growth of other voice messaging service providers by denying them an important telephone service. This action made it much easier for BellSouth to enter the voice messaging market in Georgia and much harder for existing voice messaging services to compete with BellSouth. Georgia MemoryCall Order at 31-34.

BellSouth also used its position as the local telephone company to offer services that benefitted its own information services operations. MemoryCall used a service known as Simplified Message Desk Interface ("SMDI") to provide voice messaging. As implemented in Georgia, SMDI was incompatible with the technology used by almost all independent voice messaging providers. Id. at 28-30. Thus, BellSouth offered a service that, effectively, was available only to its own voice messaging operations, creating significant advantages in the voice messaging marketplace. Id.

3. Refusal to Provide N11 Numbers

BellSouth is not the only BOC that has used its position as the only local exchange carrier to its advantage in the marketplace. In another area, the use of "N11" numbers, Cox has found that BOCs have engaged in discriminatory conduct.[18]

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17/ This and other anti-competitive aspects of BellSouth's MemoryCall offering are described in the Georgia Public Service Commission's order on MemoryCall (the "Georgia MemoryCall Order"), a copy of which is attached hereto as Exhibit 2.

18/ N11 numbers are three digit telephone numbers, which have a number from two through nine as the first digit and which end in "11". The most common uses of these numbers are 911 for emergency services and 411 for directory assistance.

Beginning with Cox's request to BellSouth in 1991, ISPs began asking BOCs to make N11 numbers and associated services available for information services. To date, all but BellSouth have refused to make those numbers available, despite an FCC determination that there is "no legal or regulatory impediment" to providing service through N11 numbers.[19] See N11 Codes and Other Abbreviated Dialing Arrangements, Notice of Proposed Rulemaking, 7 FCC Rcd 3004, n. 1 (1992).[20] Typically, the BOCs have claimed that N11 numbers are reserved for "non-commercial" or "public interest" uses, even though official numbering authorities have not reserved N11 numbers for these purposes. At the same time, BOCs continue to use N11 numbers for their own commercial advantage in competitive markets and have expanded those uses even while they deny access to ISPs.

N11 numbers are used for commercial purposes in a variety of ways. The most common is directory assistance call completion, which is offered in many BOC territories through the N11 number 411. Directory assistance call completion gives the BOC a significant advantage in the intraLATA toll market, because callers who use directory

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19/ BellSouth only made an N11 available to Cox for information services once the Georgia PSC ordered a trial of N11 for information services.

20/ While the Commission initiated its rulemaking on N11 numbering policies nearly three years ago, it has not yet adopted an order confirming its tentative view, expressed in its Notice and in an advisory letter of its General Counsel, that there is no regulatory impediment to making these numbers available to ISPs. While most BOCs have used this as a pretext to delay providing these numbers to competitors, it is plain that FCC regulation to date has failed to address the significant competitive concerns related to BOC usse and assignment of N11 numbers.

assistance call completion are not given a choice of carriers, regardless of current state policies regarding intraLATA toll competition.[21]

BOCs also use N11 numbers to sell competitive services. In some areas of the country, 811 is used to reach the telephone business office, which sells both monopoly local services and competitive services such as voice messaging. The advantage of using the N11 number to sell these competitive services is significant. In a similar vein, many BOCs use 611 for access to repair service both for faults in the telephone network and for problems with customer-owned inside wiring. Again, the telephone company's competitive inside wire repair service benefits greatly both from being offered through the same number as regular telephone service repair and from the convenient, abbreviated nature of the access through 611.

These existing competitive uses of N11 numbers demonstrate that BOC claims that N11 numbers are reserved for "non-commercial" uses are simply a diversion from the discriminatory nature of their refusal to provide N11 numbers to non-BOC information services providers. Moreover, BOC uses of N11 numbers, both generally and for commercial purposes, have increased noticably since ISPs first asked for those numbers to provide information services. For instance, within the last year Bell Atlantic began using 611 for access to all of its repair services in the Washington, D.C. metropolitan area, despite the pendency of the FCC rulemaking on N11 numbers and the pendency of proceedings

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21/ It appears likely that the same results would follow if BOCs were permitted to provide interLATA service. Thus, interLATA competitors would be directly harmed by the BOCs' continuing, often state-mandated, monopoly on local exchange service and directory assistance.

regarding the appropriate uses of N11 numbers in two of the three jurisdictions where the new 611 service was introduced.[22]

Thus, BOCs consistently and persistently discriminate against independent ISPs. In fact, as the Georgia experience demonstrates, they continue to discriminate, often by shifting to new methods, after they are caught. The potential and incentive for discrimination will be, if anything, much greater if the BOCs are permitted into the interexchange and manufacturing markets where the potential benefits of discrimination are much greater.

### B. BOCs Have Abused Their Monopoly Position by Taking Advantage of Their Local Exchange Monopolies in Competitive Markets.

BOC abuses are not limited to discrimination. They also take advantage of their monopoly status in the local exchange to create advantages for themselves in competitive markets. Two particularly prominent examples of such behavior were discovered by the Georgia Public Service Commission in its MemoryCall proceeding.

First, certain BellSouth policies simply made it harder for end users to purchase competitive voice messaging products than to purchase MemoryCall. Voice messaging requires an end user to purchase some form of call forwarding, usually call forwarding variable, at the same time the user buys the voice messaging service. (The call forwarding service is necessary so that calls will be sent to the voice messaging provider.)

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22/ See Petition of the Washington Post Company Requesting the Assignment of an N11 Code, Case No. 8582 (Md. PSC); Ex Parte: Investigating N11 Access to Information Service Providers, Case No. PUC930019 (Va. SCC).

While BellSouth would permit independent voice messaging providers to order call forwarding for their customers, it was impractical for them to do so because BellSouth also held them liable for any charges that were not paid by the end users. BellSouth's MemoryCall service, which was offered through BellSouth's regular customer service representatives, was never held liable for end user telephone service charges because the end users had ordered their call forwarding services directly. Georgia MemoryCall Order at 31-41. As a result, end users calling BellSouth could purchase both services with one phone call, but end users who wanted to purchase a non-BellSouth voice messaging service could do so only by calling the voice messaging provider first and then separately ordering call forwarding from BellSouth. The ability to offer "one stop shopping" was a significant marketplace advantage for BellSouth. Id. at 36-37.

BellSouth further leveraged this advantage through a process known as "unhooking." When an end user called to order call forwarding, BellSouth customer service representatives asked whether the end user was purchasing voice messaging service and, if so, suggested that the end user should purchase BellSouth's MemoryCall service instead. The Georgia Public Service Commission found unsurprisingly that this practice, greatly disadvantaged independent voice messaging providers. They not only were unable to provide all of the services needed by their customers, due to BellSouth's billing practices for call forwarding services, but the voice messaging providers were forced to send those customers to a company that actively tried to convince them to switch to a different voice messaging service. Id. at 38-41. The FCC, in its Computer III Remand Order, specifically found that this practice was unlawful.[23]

### C. BOCs Cross-Subsidize Their Existing Businesses.

Another important competitive danger is cross-subsidization. Cross-subsidization is a risk any time that a regulated monopoly enters into unregulated or lightly regulated competitive businesses. There are significant incentives to shift revenues from the regulated business to the competitive business and to shift costs from the competitive business to the regulated business. The evidence of the past ten years demonstrates that the BOCs can and do succumb to this temptation.

Recent proceedings in Georgia highlight the risk of cross-subsidization. Following extensive hearings, the Georgia Public Service Commission found that BellSouth had both the incentive and the ability to engage in cross-subsidization of its competitive businesses to the detriment of captive telephone ratepayers.[24]

As a result of its findings, the Georgia Public Service Commission decided to require an audit of BellSouth's operations in Georgia to determine if there were actual cross-subsidies. The audit, completed in September, 1994, found that there are significant cross-subsidies running from BellSouth's regulated (i.e., monopoly) services to unregulated (i.e.,

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23/ See Computer III Remand Proceeding, 6 FCC Rcd 7571, 7623 n.211 (1991). Ironically, the FCC did not impose a forfeiture or any other sanction on BellSouth, despite this explicit finding.

24/ See Investigation into Cross Subsidy Matters Relating to Southern Bell Telephone and Telegraph Company, Docket No. 3987-U, August 25, 1992.

competitive) services.[25] These subsidies included improper allocation of income tax benefits, assignment of costs of unregulated services to regulated accounts and shifting costs of unregulated customer premises equipment to regulated accounts. The audit also found there was good cause for more careful scrutiny of intracompany transactions and recommended referral of information regarding transactions with foreign affiliates to federal and state tax authorities.

The cross-subsidies are particularly significant for two reasons. First, they show how a BOC can leverage its current monopoly in local exchange services to benefit its operations in competitive markets. Second, cross-subsidies hurt consumers both as ratepayers and as purchasers of competitive services. The damage to the markets for competitive services is particularly pernicious, because it reduces consumer choice and, in the long run, is harmful to the economy as a whole.

Moreover, cross-subsidization is not an isolated event. Several audits have found significant cross-subsidies between regulated and unregulated BOC businesses. For example, the National Association of Regulatory Utility Commissioners ("NARUC") recently released the results of an audit of Pacific Bell.[26] This audit uncovered substantial cross-subsidization despite the presence of numerous accounting "safeguards":

> Regulatory agencies' heavy reliance on non-structure safeguards, such as cost allocation systems and project tracking systems may be misplaced. These systems and procedures appear to be inadequate to ensure that cross-subsidizations will not occur.

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25/ A copy of the executive summary of the audit report is attached hereto as Exhibit 3.

26/ See supra note 12.

> The concern is that these safeguards may be creating the perverse effect of encouraging cross-subsidizations.[27]

The NARUC Audit focused on three areas: research and development, enhanced services and yellow pages. In each area, the auditors found that new products whose revenues would flow to Pacific Telesis shareholders were developed at ratepayer expense. For example, in the research and development area, the auditors made the following findings:

- Pacific Bell's subject experts working on both competitive and non-competitive projects have not been correctly segregating their time between the two business sectors.
- Pacific Bell made certain infrastructure modifications at the expense of the general body of ratepayers. Those modifications were mainly to accommodate the development of its competitive enhanced services. However under Pacific Telesis' corporate policy, only its shareholders will realize the potential profits from these projects.
- R&D expenditures are co-mingled with other operating expenses. Pacific Bell is unable to delineate expenditures on a per project basis. . . . Because tracking procedures for R&D projects are arbitrarily applied, opportunities for cost shifting occur.
- The Pacific Telesis Group's decision to retain the potentially lucrative PCS retail line of business for its shareholders is contrary to the regulatory concept that the rewards of a new product should be assigned to the part of the business that took on the risks of developing the product. Research and development costs for PCS were borne by the general body of telephone ratepayers.[28]

The results of the NARUC Audit of Pacific Bell and the Georgia PSC audit of BellSouth demonstrate that cross-subsidy is not an isolated occurrence, but rather a normal

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27/ NARUC Audit at ii.

28/ NARUC Audit at B-10 - B-12.

business practice. The BOCs consistently and systematically abuse their local exchange monopoly to the determinant of competitors and the public and this serious problem only would worsen if the Decree were vacated and BOCs were permitted to enter the interexchange and equipment manufacturing markets.

D. Existing Regulations Will Do Nothing to Prevent BOC Abuses of Their Monopoly Power.

The BOC response to descriptions of their abuses is to claim that the abuses are in the past and that existing regulations are sufficient to prevent any further abuses of monopoly power. Motion at 18. Nothing could be further from the truth. In reality, the abuses described above have taken place under current regulation and the BOCs are making every effort to tear down existing safeguards, leaving nothing to protect against monopoly abuse.

First, it is important to recognize that the abuses described above have taken place under the current regulatory regime. The MemoryCall case in Georgia, the Georgia ONA proceeding, the BOC refusal to provide N11 service and the cross-subsidy determinations all took place under the same regulatory regimes that are in place today.[29/] It is no surprise, consequently, that the Ninth Circuit recently held that the FCC has failed to show that its nonstructural safeguards regime is sufficient to protect against monopoly abuses

29/ MemoryCall and the Georgia ONA proceeding took place under the FCC's original Computer III rules, but there is no material difference between those rules and the Computer III Remand Order rules.

by BOCs in the information services marketplace.[30] There is every reason to think that current rules, having failed to prevent these activities before, would continue to do so in the future.

What is most striking about these cases is that, even when BOCs are caught engaging in anti-competitive activities, they are not penalized. The FCC, after acknowledging the finding of the Georgia PSC that BellSouth had engaged in improper conduct in the MemoryCall case, imposed no sanctions.[31] In fact, the FCC preempted the Georgia Public Service Commission's decision imposing sanctions on BellSouth for its MemoryCall abuses.[32]

While current regulations are not sufficient to protect against abuse, the BOCs constantly work to reduce the effectiveness of those regulations even further. For instance, BellSouth recently proposed a regime in Georgia that would have eliminated all regulation of most of its services, including many services that are vital to information services providers. The BellSouth proposal would, among other things, have permitted price discrimination for such "competitive" services as call forwarding and touch tone.[33] The BOCs also have been the chief proponent of FCC preemption of state regulation of information services, in large

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30/ California v. F.C.C., slip op at 12768. The Ninth Circuit specifically cited the MemoryCall case as an example of the failure of existing regulation. Id. at 12766.

31/ See Computer III Remand Order, 6 FCC Rcd at 7623 n. 211.

32/ See Memorandum Opinion and Order, 7 FCC Rcd 1619 (1992)

33/ A copy of this proposal, dubbed "Georgians FIRST" by BellSouth, is attached as Exhibit 4.

part because state regulation has been considerably more stringent than federal regulation.[34] BOCs have fought against all efforts to permit the growth of competition to their businesses, even while working to eliminate protection against their abuses of monopoly power.[35] In essence, the BOC strategy is to eliminate all barriers to their unfettered use of monopoly power while restraining the development of competition in the local exchange business.

Moreover, BOCs already are working to bring their monopoly power to bear in markets closely related to interexchange and equipment manufacturing. As described above, monopoly directory assistance service is being used to protect BOC intraLATA toll revenues. Similarly, BellSouth offers services ancillary to its Centrex service at rates that are better than those available to PBX users and, as found in the Georgia cross-subsidy audit, also shifts costs related to unregulated customer premises equipment to regulated accounts. The BOCs are taking these steps today, when their stakes in the toll and equipment markets are relatively small. It is almost certain that they will do much more to leverage their local exchange monopolies if they are permitted to enter the interLATA and equipment manufacturing marketplaces.

The assertion that existing regulation is adequate to prevent anti-competitive behavior by the BOC is further contradicted by recent congressional efforts to pass telecommunications reform legislation. Although one purpose of the proposed legislation

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34/ In the MemoryCall case, BellSouth initiated the FCC proceeding that preempted Georgia's responses to BellSouth's competitive abuses.

35/ See Edmund Andrews, Bell Compaies Use Regulation to Stop Rivals, New York Times, Page A1, July 24, 1994.

was to eliminate certain Decree restrictions, those restrictions were to be replaced by specific additional grants of authority to the FCC and the Department of Justice.[36] Specifically, the FCC and the DOJ were required to stage BOC entry into new markets based on their assessment of market conditions.[37] Furthermore, BOC entry into competitive markets, such as electronic publishing and video programming, would have been subject to substantial safeguards, including a separate subsidiary requirement that the FCC has abandoned for BOC enhanced services. Thus, it was the opinion of at least the House of Representatives and the Administration that existing law and regulation is an inadequate replacement for the Decree.

The FCC is a strong advocate of reform of the Communications Act. Indeed, in explaining why a number of recent initiatives have not been able to withstand judicial scrutiny, the Commission has argued that such judicial losses demonstrate the need for comprehensive legislative reform. While the Commission has advocated BOC entry into certain competitive markets, including cable television and PCS, at no time has the Commission ever stated that existing federal law is an adequate substitute for the Decree.[38]

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36/ Legislation would have left portions of the Decree in place, notably the equal access requirement.

37/ For example, the Antitrust Reform Act of 1993 (formerly the Antitrust and Communications Reform Act of 1993) (H.R. 3626), which passed the House by an overwhelming majority, required the FCC and the DOJ to apply standards to BOC entry into new markets that would have been substantially similar to the standards applied by this Court in reviewing MFJ waiver requests.

38/ "[A]ny plan for removing [MFJ] restrictions must provide adequate safeguards to preclude the ROBCs from using their existing market power in the local exchange to undermine competition in markets they seek to enter." Statement of Reed E. Hundt, before the Committee on Commerce, Science and Transportation, United States Sènate (Feb. 23, 1991). Even the BOCs acknowledge that the FCC would have to develop rules for cost

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